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Persistent institutional malfunctioning in the Eurozone

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ABSTRACT

Institutional change in the Eurozone is driven by the need to ensure the immediate survival of the euro rather than confronting the structural weaknesses of the common currency. The failure to deal with underlying weaknesses is demonstrated by the policy of "selective support", whereby markets and instruments considered vital for the survival of the euro are often adopted under pressure. This type of support is most prominently demonstrated by the TARGET2 clearing system within the Eurosystem of central banks. The system allows the euro to survive but also facilitates the rise of intra-EMU imbalances, as is reflected in divergent claims and liabilities of member states, leading Germany to accumulate intra-EMU claims on others. Instability thus becomes entrenched in the Union, while Germany maintains a hegemonic position.

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Introduction

The policies adopted by the Economic and Monetary Union (EMU) of the European Union (EU) since the systemic crisis of 2007–9 and the pandemic crisis of 2020–21 point to a tacit principle: the EMU engages in institutional change but only as a last resort and at the minimum level required to keep the euro alive. Reform that aims at fostering greater stability by improving the functioning of the monetary union is generally absent. The result is that institutional changes tend to mask the underlying asymmetries of the EMU and ultimately exacerbate its divisive tendencies.

Fostering greater stability in the EMU would require decisive institutional measures, such as imposing constraints on cross-border capital flows or devising rebalancing mechanisms of the cross-border payments among its member states. But the problem is that such steps would effectively

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This article has been corrected with minor changes. These changes do not impact the academic content of the article.

hamper the euro from functioning as the single and common currency of the EMU in its current form.

This deeply contradictory situation ultimately derives from the conditional (and regional) hegemonic power of Germany in the EU, which is underpinned by the euro (Lapavitsas and Cutillas 2022). For Germany, it is imperative that the euro should continue to function as the single and common currency of EMU member states, as it currently does. It is not, however, necessary – and might be against Germany's interests – to undertake the profound institutional changes that would result in greater stability for the EMU.

To be more specific, the EMU frequently deploys policies of "selective support" across sectors and instruments to ensure the survival of the euro. Since the euro acts quintessentially as the organizing instrument of the economies of the Eurozone overseen by Germany, the resulting institutional changes are implicitly circumscribed. On the one hand, they must be adequate to allow the euro to continue to organize the financial and commodity markets of the EMU, even if the outcomes are asymmetric for member states. On the other, they must not be so drastic as to alter the current (asymmetric) organizing role of the euro and hamper German preeminence. From the perspective of Germany, the internal mechanisms of the EMU must be continually patched up to allow for the survival of the euro, but they must not be systemically transformed.

The policy of "selective support" inevitably contributes to further imbalances amongst EMU member states. In recent years this tendency has emerged most prominently via capital flows driven by financial motives and by the accumulation of contingent debt relations. Evidence of the exacerbation of the imbalances was provided in the 2020s by the recurrence of rising yield spreads and the polarization of liquidity flows. This is the other side of the coin for German hegemony in the EMU.

This paper makes two contributions in this regard. First, it reconsiders institutional change in the Eurozone and provides an original interpretation of its driving forces. Thus, it contributes to the literature on European integration including the political economy of the operations of monetary institutions, ranging from the analysis of the working of the ECB (Diessner and Lisi 2020; Moschella and Diodati 2020; van Doorslaer and Vermeiren 2021) to the entanglements between public and private institutions (Smith, Wagner, and Yandle 2011; Braun 2020) and programmes of fiscal and investment expenditures in Europe and the Eurozone (see Mertens and Thiemann 2018, 2019).

Second, it offers a novel analysis of the TARGET2 clearing system that is instrumental to the EMU and has been extensively discussed in the literature, for instance, Sinn and Wollmershäuser (2012), Auer (2012), Cecioni

and Ferrero (2012), and S. G. Cecchetti, McCauley, and McGuire (2012) as well as the more recent evaluations by Eisenschmidt et al. (2017) and Minenna, Dosi, and Roventini (2018). Crucially, the paper clarifies the nature of TARGET2 and offers a political economy interpretation of the system as an instrument of hegemonic power. Thus, it contributes to the economic, political, and legal analysis of the denomination of intra-EMU debt (Lapavitsas 2018; Durand and Villemot 2020).

The structure of the paper is as follows. Section 2 analyses the changes that have occurred over the last fifteen years in the institutional setup of the Eurozone, with a specific focus on monetary, fiscal, and financial policies enacted. Section 3 argues that structural weaknesses have remained a feature of the EMU since the changes in Europe and the ECB have occurred not to foster stability but to perpetrate the functioning of a hierarchical Union. Such weaknesses have led to a policy of "selective support", most prominently via the TARGET system. TARGET2 is explored in detail in section 4 by distinguishing between the mechanism and the resulting member-state balances, providing a political economy interpretation of intra-EMU imbalances. Section 6 concludes.

Institutional changes in the EU and the ECB since 2007–9

The aftermath of the global crisis of 2007–9 and its spillover into the Eurozone crisis of 2010–12 triggered a series of institutional transformations that underpinned the response of the EU when the pandemic struck in 2020. These transformations have occurred along three dimensions: fiscal, financial, and monetary. The pandemic shock led to a further round of changes: on the one hand, monetary policy expanded further but without abandoning the unconventional form it took in the second half of the 2010s; on the other, austerity was lifted to a considerable extent, exhibiting a significant change in fiscal policy from the 2010s.

Fiscal reform

The changes in the fiscal space encompassed both the national fiscal policies of member states and the creation of regional fiscal mechanisms. The adoption of austerity in the 2010s had a plain intention: avoiding the imposition of costs of adjustment on Germany by forcing internal deflation onto southern peripheral countries hit by the crisis.

Instead of dealing directly with the structural imbalances created within the EMU due to German wage repression in the 1990s and 2000s, the union forced fiscal austerity on its weaker member states. They were obliged to combine public spending cuts and tax increases with widespread

deregulation in labor and product markets with the aim of lowering unit labor costs and thus restoring competitiveness. Austerity aimed not only at decreasing public deficits, but also at reversing current account deficits. At the same time, austerity had strong negative effects on economic growth, resulting in rising overall public debt-to-GDP ratios (Alesina, Favero, and Giavazzi 2019).

Between late 2011 and early 2012, the adoption of the strategy of constraining domestic fiscal policy gave rise to several institutional transformations of the EU. Among these, the Fiscal Pact, the Six-Pack, and the Two-Pack reforms stood out by hardening the terms of fiscal policy and public debt across the EU and formalizing austerity into the constitutional framework of the union. At the same time, the reforms were also complex, detailed, and inherently dysfunctional, thus in practice leaving room for maneuver for member states.

At the regional level, two relevant institutional changes are worth mentioning: the proposal for the issuance of Eurobonds and the creation of off-balance-sheet fiscal agencies. The creation of Eurobonds to lower borrowing costs would involve some degree of debt mutualization across member countries (Brunnermeier, James, and Landau 2016), which was strongly resisted by Germany on the grounds that the country would not take responsibility for the costs of public finance in other member-states. The Eurobond proposal was thus never enacted. However, off-balance-sheet fiscal institutions in practice shaped the fiscal support offered supranationally to member countries.

Financial and monetary reform

The fiscal changes were a direct result of the crisis of funding faced by peripheral states in the Eurozone crisis. The financial and monetary changes across the EU, on the other hand, aimed at fostering the centralized position of the ECB in the EMU as well as confronting the turmoil of the Eurozone crisis (Murau and Giordano 2022).

The relevant institutions sought to support regional banking systems (the Single Resolution Fund, SRF) as well as countries in financial distress (the European Stability Mechanism, ESM); these institutions were added to the already existing European Investment Bank (EIB) and European Investment Fund (EIF) (Guter-Sandu and Murau 2022). Their establishment was preceded by the setting up of temporary funds that managed bailouts of members states and were urgently introduced in May 2010. These included the European Financial Stability Fund (EFSF), created as a private institution located in Luxembourg and operating under British law, and the European Financial Stability Mechanism (EFSM), both of which

were mobilized to provide financial support to Ireland, Portugal, and Greece without infringing the so-called no-bailout clause, that is, article 125 of Treaty on the Functioning of the EU.

At the heart of the financial reforms lay commercial banking. The sector represented a key weakness of the EMU given the close connection between a national banking sector and its respective government bond market. The link could rapidly become a 'doom-loop' as the acquisition of government debt by banks could lead to failure if government creditworthiness declined, potentially culminating in a simultaneous banking and government debt crisis (Pisani-Ferry 2012).

Consequently, strengthening the capital and liquidity requirements of banks became a prime concern for European regulators. Reforms introduced recovery and resolution regulations on failing banks to limit the liability of taxpayers for losses, and at separating risky financial activities from the practices of deposit-taking banks as happened in the US with the Dodd-Frank Act or in the UK with the introduction of 'ring-fencing' (Liikanen 2012; Lehmann 2016).

Presumably, the reforms also represented steps toward completing the EMU by integrating European banking sectors and financial markets. The Eurozone crisis had highlighted the fragmentation of banking sectors and further caused the fragmentation of money markets along national borders (Abscal, Alonso, and Mayordomo 2013; Eisenschmidt et al. 2017). For the EMU, the integration of national banking sectors – what became known as the Banking Union – would be a vital advance since it would create a homogeneous banking system as well as eliminating public bailouts of private banks (Bellia and Maccaferri 2020).

In practice, the creation of the Banking Union proceeded very slowly during the 2010s and remained incomplete. The failure reflected the constrained functioning of European money markets, which remained poorly integrated across borders as well as being dominated by the ECB through unconventional monetary policy (van Rixtel and Gasperini 2013; Coeure 2013). The malfunctioning of the European money markets stemmed, above all, from the lack of a safe European financial asset that could be used as collateral across the financial system. Various government bonds with distinct yields are still in practice used in secured operations for liquidity. In sum, the fragmentation that was supposed to be overcome via the Banking Union persisted and appeared as variable spreads among sovereign bonds in the EMU.

The European Central Bank dictated the changes that took place in the monetary field of the Eurozone (Giordano and Goghie 2023). The Eurozone crisis allowed the ECB to make use of policies that went beyond the provisions of its original statutes to a certain extent, but its ability to

expand the supply of money was limited by rules constraining the acquisition of public (and private) debt since its inception. Nevertheless, the ECB gradually accrued powers of intervention reminiscent of the Federal Reserve, thereby engaging in quantitative easing in the 2010s and enormously expanding its balance sheet, while dominating the money market. Such changes were tacitly accepted by the German ruling bloc because they guaranteed the survival of the euro.

The nature of the transformation of the ECB started to become clear in the middle of the 2010s, after a rapid change in the operations of monetary policy from Open Market Operations (carried out through repos) to the European version of quantitative easing. The Lisbon Treaty of 2007 forbids the ECB from buying state debt, but its provisions were side-stepped in 2014–15, under the presidency of Mario Draghi, when the ECB systematically engaged in quantitative easing through the so-called Asset Purchase Programmes (APP). The APP is made of four distinct programmes (CSPP, PSPP, ABSPP, CBPP3) which are carried out in different ways.[1] However, the bulk of the APP consisted of the Public Sector Purchasing Programme in which each National Central Bank purchased in the secondary markets the government bonds of its respective sovereign issuer.

The impact of quantitative easing can be seen through the consolidated balance sheet of the Eurosystem, which encompasses the ECB as well as the National Central Banks (NCBs) of member states. Within the Eurosystem, the NCBs operate as branches of the ECB and implement the common monetary policy designed by the ECB according to directives set out by its Governing Council.

The assets and liabilities of the Eurosystem grew steadily after the outbreak of the Great Crisis of 2007–9 but escalated rapidly after 2014, when quantitative easing was implemented. By 2019 they were nearly 5 trillion euros each, compared to 2 trillion euro in 2010. In sum, outright purchases of securities by NCBs significantly raised the reserves of the commercial banks of the Eurozone held at individual NCBs. In effect, the Eurosystem injected huge volumes of liquidity to banks by acquiring equally huge volumes of securities.

The pandemic shock: break in fiscal austerity, continuity in monetary policy

The outbreak of the pandemic crisis, 2020–21, forced a dramatic change in fiscal policy with the lifting of strict austerity. At the same time, the EMU continued along the same lines in monetary policy but greatly expanded the liabilities of the Eurosystem through asset purchases. These policy changes were largely caused by the need to keep the euro afloat rather than

aiming to improve the fundamental functioning of the EMU. They were underpinned by the hegemonic concern of Germany to prevent the monetary union from collapsing. Even the relaxation of austerity stemmed from the need to deploy fiscal policy in an environment in which monetary policy was not sufficient to guarantee stability.

The break in fiscal policy involved three distinct and escalating changes in Eurozone fiscal rules: first, the temporary suspension of the more stringent Stability and Growth Pact (Schuknecht et al. 2011); second, the temporary (until June 2022) removal of barriers to public support for industrial sectors, which was previously prohibited under Article 107(1) TFEU, by means of the State aid COVID Temporary Framework (ECB 2020); and third, the creation of the joint fiscal program under the Next Generation EU – a combination of grants and loans totaling to a maximum of around €750bn. The latter represents the biggest break from traditional EU rules as the program was funded through joint issuance of bonds by the European Commission in capital markets.

At the same time, the assets and liabilities of the Eurosystem escalated quickly to unprecedented levels, as was already mentioned in the previous section. The increase was partly due to provision of liquidity to banks via the ECB's Long-Term Refinancing Operations, but mostly through the Pandemic Emergency Purchase Programme (PEPP) and the continuation of the APP. The PEPP further loosened the already existing monetary practices of the EMU, including a waiver of eligibility requirements for Greek government debt, which had been excluded from the APP due to its low quality, and the removal of any self-imposed purchase limits by the ECB. Moreover, the regulations constraining ECB acquisitions were greatly relaxed in 2020. In effect, the PEPP acted as an emergency APP during the pandemic, and by 2022 it had resulted in very substantial holdings of public bonds by the Eurosystem, as is shown in Figure 1.

The rapid growth in public debt holdings since the middle of the 2010 and especially during the pandemic inevitably meant that the Eurosystem started behaving as a key participant in capital markets. This function was in addition to its already established presence in the money markets aiming to safeguard the transmission mechanism of monetary policy. It represents a big leap for the central bank of the EMU, though the function can be readily found among the central bank of other advanced countries, especially the US Federal Reserve. The systematic interventions of the NCBs and the ECB in the financial markets led to a reduction in the divergence in interest rates on the ten-year government bonds between core and peripheral states within the EMU.

Figure 2 depicts the trajectory of such spreads relative to the benchmark German Bund rate. The solid lines show the spreads of selected EMU

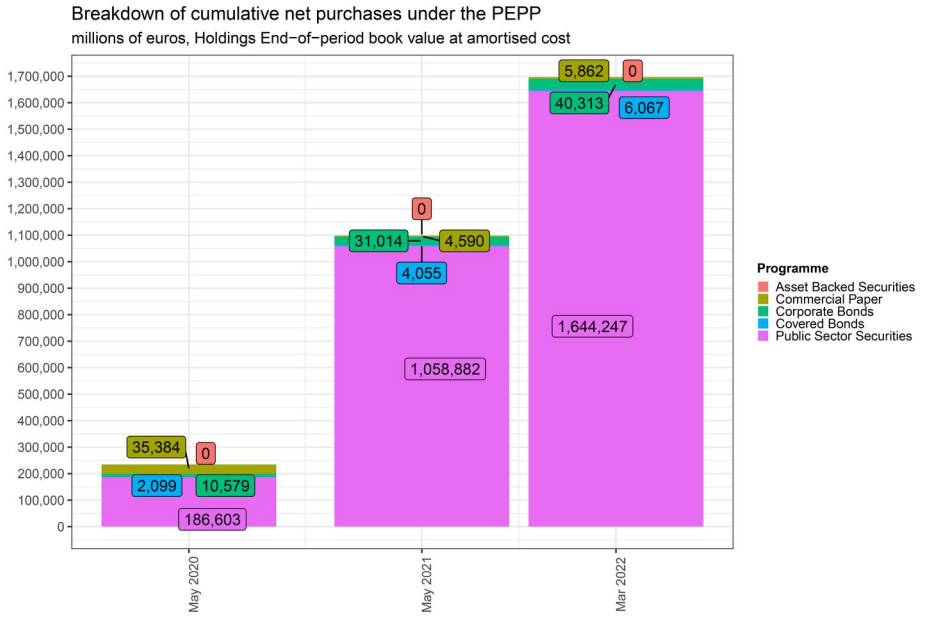

Figure 1. Composition of Eurosystem holdings under the Pandemic Emergency Purchase Programme, 2020–2022, mn of euros.
Source: ECB.

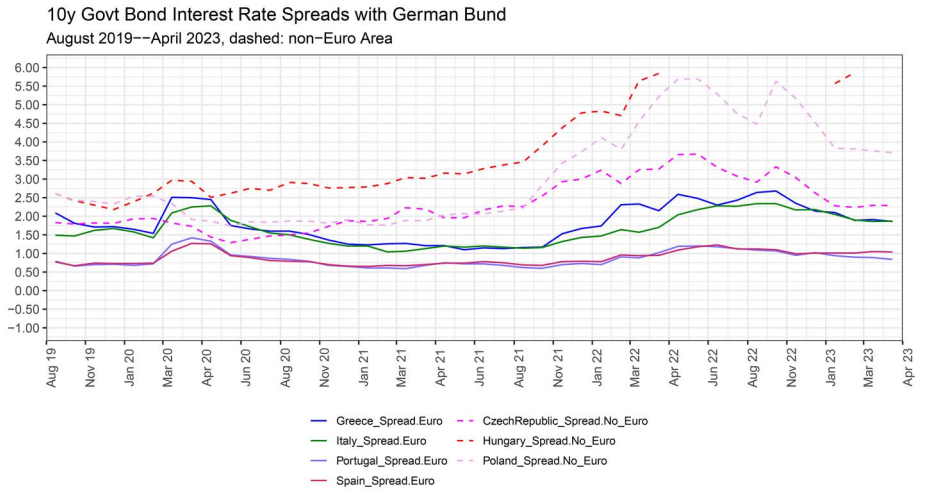

Figure 2. Ten-year Interest Rate Spreads for Government Bonds of Selected Countries against the German Bund.
Source: ECB.

countries, while the dotted lines refer to non-EMU countries. It is apparent that EMU policy succeeded in compressing spreads during 2020–21 and certainly compared to non-EMU countries. Even after the rise in inflation and the resurgence of spreads in 2022, EMU countries showed more modest increases.

However, these policies also reflect the institutional malfunctioning of the EMU, including the problematic architecture of its monetary and financial fields. Particularly important is the decentralized implementation of monetary policy by individual NCBs. The operations of the Eurosystem take place primarily through the National Central Banks (NCBs) and thus appear on the balance sheet of each NCB. One result is that the balance sheet of the ECB itself accounts for a small part of the total balance sheet of the Eurosystem – less that 20% in early 2021.

A further result is that the creation of central bank liabilities gives rise to considerable imbalances among member states since each NCB is responsible for purchasing sovereign debt issued solely by its own government. Each NCB "chases" its own government's bonds (e.g., Banca d'Italia can only purchase Italian sovereign bonds), but the owners of these bonds are located both domestically and abroad. Consequently, transactions under the PEPP inevitably generate cross-border flows of reserves reflecting the investor mix of a given sovereign bond.

An equally important institutional deficiency is the uneven depth of money markets (specifically interbank markets) across member states. The ultra-lax monetary policy of quantitative easing temporarily masked the problem by creating excess liquidity within the Eurozone, thus decreasing the funding constraints of monetary institutions (mostly commercial banks). This was evidenced by the trajectory of sovereign bond spreads, shown in Figure 2, which were again increased in 2020 as the pandemic hit and were temporarily reduced by ECB intervention (Corradin, Grimm, and Schwaab 2021).

However, the excess liquidity created by the Eurozone during this period allowed commercial banks to reallocate funds across borders (Baldo et al. 2017). The result was the concentration of reserves within the EMU and the emergence of substantial intra-EMU reserve flows. As is shown in Figure 3, the excess reserves of private credit institutions generated after the introduction of quantitative easing were gathered primarily in the accounts of the Bundesbank and Banque de France.

Commercial banks across the EMU preferred to allocate their excess reserves in the jurisdiction of Germany and France even when the financial transactions they undertook occurred elsewhere in the EMU. Furthermore, the sharp fall in excess reserves by all NCBs in late 2022 offers further evidence of the significance of internal liquidity management by banks in this environment. Commercial banks responded to the rapid increase in the EMU interest rate in a similar way across all jurisdictions, rapidly contracting their reserves.

The persistence of the underlying institutional weaknesses of the Eurozone was certainly perceived by the authorities as was made clear by the introduction of the Transmission Protection Instrument by the ECB's

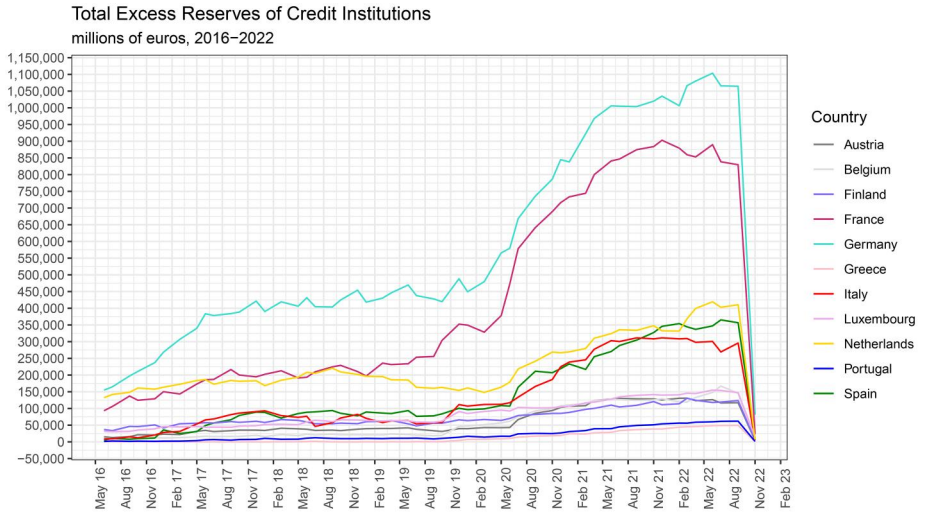

Figure 3. Total Excess Reserves of Credit Institutions at each NCB, 2016–2022, mn euros. Source: ECB Statistical Data Warehouse.

Governing Council in July 2022. This mechanism is an attempt to prevent the return of instability in European sovereign bond markets, the third such effort following the adoption of the Securities Market Programme in 2010 and the Outright Monetary Transactions in 2012.

All three of these operations adopted similar guidelines, above all, the purchasing in secondary markets of government debt securities issued by member states that found themselves in financial distress. In line with the previous interventions by the ECB, however, the Transmission Protection Instrument does not make provision for risk-sharing or loss-sharing (Bernoth et al. 2022). Once again, the stabilizing policy does not resolve but merely circumvents one of the key problems that has marked the operations of the Eurosystem from the beginning.

The asymmetric allocation of bank reserves casts light on the internal institutional malfunctioning of the EU (and on the dominant role of Germany and France within it). However, the asymmetry does not appear in the consolidated balance sheet of the Eurosystem. In contrast, TARGET balances reflect accurately the net positions of NCBs against one another for euro-denominated flows. Thus, they offer clearer evidence of the malfunctioning of the EMU, as is shown in the following section.

TARGET2: perpetuating persistent imbalances in the EMU

There is no doubt that TARGET was the most important mechanism allowing the Eurozone to survive during this period, while suppressing (but not eliminating) its underlying weaknesses. This is the key payment system of the Eurozone, which facilitates the flow of euros amongst market

participants in the EU regardless of their location, and ultimately settles transactions in central bank money.

Relevant transactions could originate in the flows of commodities, loanable capital, or result from simple transfers; since 2017, the system also carries out the settling of securities transactions. Crucially, no significant changes have occurred to the TARGET system in the wake of the Eurozone crisis, except for the fundamental step of allowing gigantic imbalances to build up within it.

The TARGET system was introduced in 1999 and was updated to TARGET2 in 2008.[2] It is the main instrument used to centralize and instrumentalize the ECB within the EMU (Murau and Giordano 2022). The decisive moment was the decision of the Governing Council of the ECB to adopt the practice of novation in the early 2000s. TARGET balances were originally devised as bilateral positions between pairs of National Central Banks, and are still recorded during each day as outstanding claims and liabilities between single NCBs. At the end of the day, however, the claims and liabilities of a single NCB within TARGET are netted and shifted onto a sole claim against (or a liability to) the ECB. Consequently, each NCB shows a single position vis-à-vis the ECB instead of having several positions against other NCBs. Novation has thus made the ECB the common point of reference in operations among all NCBs in the Eurosystem.

The technical nature of TARGET balances reflects the need for the assets and liabilities of each NCB to match for accounting purposes. TARGET balances are added or subtracted to balance the amount of central bank reserves that are gained or lost within the jurisdiction of a particular NCB. If, for example, an individual in Germany received a payment from an individual in Italy via their respective commercial banks, the transaction would ultimately be settled through TARGET. In the first instance, therefore, Banca d'Italia would record fewer reserves than it originally had, whilst the Bundesbank would record more reserves than are required to balance its assets. To restore the balance and clear the payment, the TARGET system would add a fresh sum as a liability of Banca d'Italia on its balance sheet and simultaneously record the same sum as an asset of the Bundesbank on its balance sheet. With the introduction of novation, the position of each central bank relative to each other would be reflected in the position of each relative to the ECB.

The creation and use of the TARGET system is fundamental to the EMU, as it apparently eliminates the distinction between domestic and cross-border payments, allowing the euro to function at once as the domestic and the international money of the monetary union. The automatic creation of TARGET balances for every transaction that is settled in central bank money (netted at the end of each day) is obviously necessary to ensure that the euro

has the same exchange value across EMU member states. Otherwise, a premium or a discount would have arisen for the balances of individual central banks depending on whether their reserves were rising or falling.

At first sight, therefore, it appears that TARGET balances are simply an accounting device to ensure the practical functioning of the euro. But reality is far more complex. TARGET balances show the workings of money as the organizing element of the Eurozone and demonstrate the underlying hierarchical nature of the monetary union.

To be more specific, the balances of the ECB in the current TARGET2 system directly reflect its involvement in the monetary policy operations of the Eurosystem as well as in the provision of Foreign Exchange to European financial institutions through the Swap Lines that the ECB has with other central banks (most importantly the US Federal Reserve for dollar liquidity to European banks). Figure 4 shows the cumulative TARGET2 balances for Eurozone member countries since March 2008, marked by the main economic and political events of the 2010s. It is apparent that the ECB balance has become progressively worse, and notably so after the adoption of quantitative easing in 2014. Moreover, the spikes in 2008 and 2020 were due to the ECB intermediating the disbursement of dollar swap lines to commercial banks. In both respects, its balance sheet has been fundamental to the survival of the EMU.

Two remarkable developments stand out in Figure 4:

i. TARGET2 balances have been increasingly polarized throughout the period, except for 2012–13. Currently, the surplus of Germany exceeds one trillion, while the deficits of Italy and Spain exceed 500 billion euro

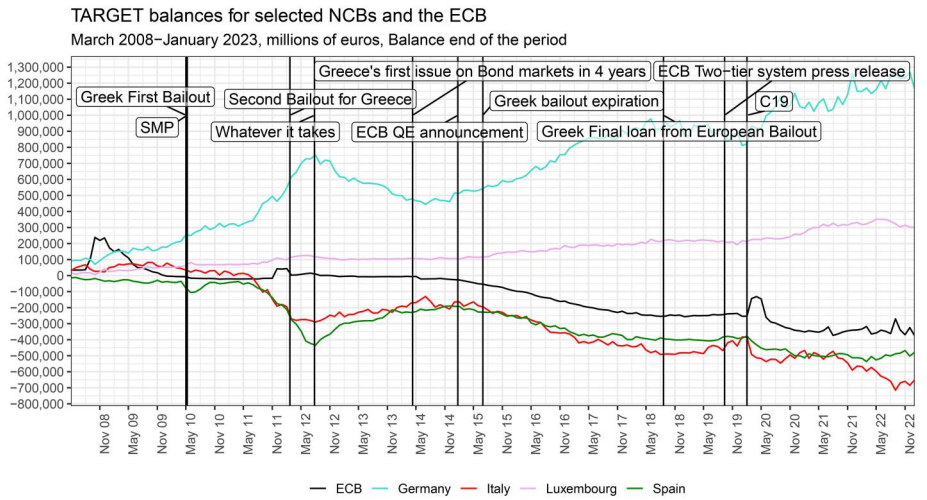

Figure 4. TARGET2 balances for selected National Central Banks and the ECB.
Source: ECB Statistical Data Warehouse.

for each country. There is clearly no rebalancing mechanism for TARGET2 within the EMU.

ii. Other peripheral countries, such as Greece, have accumulated TARGET2 deficits that may appear of limited size compared to Germany, Spain, and Italy, but are significant relative to the domestic economy. It appears that TARGET2 deficits reflect the division of core and periphery within the EMU and point to liquidity flowing from periphery to core.

Although TARGET2 balances can be quantified, as in Figure 4, the economic significance of the accumulation of surpluses or deficits cannot be immediately established, and nor can the effect on national economies be immediately ascertained. Consequently, these striking developments in EMU calls for a closer examination from a political economy perspective.

Interpreting TARGET2: mechanism and balances

The significance of TARGET2 for the functioning of the EMU can be assessed through its twofold nature, that is, as a *mechanism* and as mere *balances*. The mechanism of the TARGET2 system supports the flowing of both capital and liquidity, thus could be thought of as the "bridge" connecting the money circulating within, say, two different jurisdictions, which in the Eurozone would coincide with two member states. The existence of the TARGET mechanism guarantees that the nominal value of one euro in each jurisdiction would be maintained at par, meaning that one euro in, say, Germany could be used to settle a transaction worth one euro in, say, France.

TARGET2 balances are the accumulated outcome of such flows on either side of the "bridge". The balances represent claims or liabilities of specific member states in relation to the ECB, and by extension of a member state's central bank toward all the other National Central Banks of the Eurosystem. TARGET balances are simple financial instruments, with the peculiarity that they are not issued deliberately but *automatically* because of end-of-the-day mismatches of money flowing into and out of a specific jurisdiction. In other words, they arise as the "bridge" is used in a particular direction.

TARGET2, both as mechanism and as balances, masks the structural asymmetries at play in the EMU by maintaining the flow of payments and facilitating the settlement of obligations indefinitely since it lacks a defined ceiling for the accumulation of both assets and liabilities. But at the same time TARGET2 does not fundamentally resolve the underlying market stresses.

Economic literature has paid considerable attention to the determinants of TARGET2 balances, but without offering a concrete interpretation of the meaning and significance of the enormously diverging positions within the system. Explanations have focused primarily on three sets of causes: i) the current account, ii) the capital account and iii) the Eurosystem's monetary policy.

The first argues that TARGET2 balances derived from current account deficits in the peripheral countries that could not be funded through private markets (Sinn and Wollmershäuser 2012; Blake 2018). In effect, core countries supported the consumption of peripheral countries through TARGET2. The second stresses capital flights from periphery to core (primarily to Germany) that occur in times of crisis together with speculative capital flows driven by "fear and panic" (Cecchetti, McCauley, and McGuire 2012; De Grauwe and Ji 2012; Whelan 2014). The third remains the least explored and argues TARGET balances should be interpreted as a by-product of the ECB's monetary policy and quantitative easing programs, which are carried out in a decentralized fashion and thus spur rebalancing flows of capital across European jurisdictions (ECB. 2016a; Eisenschmidt et al. 2017; Minenna, Dosi, and Roventini 2018).

These explanations capture specific aspects of TARGET2 balances at different times but do not offer a coherent analysis of the TARGET2 system as a mechanism. From a political economy perspective, TARGET2 ought to be examined as both mechanism and balances. It then transpires that TARGET2 replaces both private and public forms of funding among member states with a hybrid form in which central bank refinancing and cross-border funding become practically indistinguishable.

The mechanism is part of the "selective support" provided by the authorities of EMU to instruments (for example, government bonds during market stress) or to sectors (for example, the financial sector under liquidity pressure). In effect, the TARGET mechanism supports flows of liquidity across borders even when inflows and outflows do not balance, as is shown by portfolio and interbank flows since the Eurocrisis. Consequently, it is fundamental to the survival of the euro, for without the TARGET mechanism there would be no single and common currency due to constrained monetary flows across member countries' borders.

To be more specific, in standard cross-border (and cross-currency) systems outside the Eurozone, payments are carried out mainly through correspondent banks. Thus, a nonresident bank opens an account with a resident bank through which it can channel payments in foreign currency. The correspondent banking system is highly effective in netting gross flows and allowing short-term imbalances to be carried over. With more permanent net imbalances, however, a funding system is required to fund the

foreign currency liabilities that have appeared as short-term imbalances. Typically, such funding would be obtained in international private markets in the form of interbank loans as deficit banks would seek to fund their net flows from surplus banks.

This funding would bear the respective interbank rate, which would adjust in response to the availability of interbank funds. Put otherwise, net payment imbalances would be financed through private loans bearing an interest rate at which lenders would be willing to finance a net imbalance. The interest rate would rise if deficits worsened and eventually no-one were willing to fund worsening imbalances. For our purposes it is important to note that net payment imbalances would first be reflected in interest rate differentials among borrowers.

If net cross-border imbalances persisted and private funding became less available to banks, an alternative funding mechanism would be required to prevent the banks of deficit countries from being altogether excluded from the international market. This mechanism at the core of contemporary capitalism essentially amounts to central banks entering into foreign exchange swap agreements with other central banks, and subsequently channeling the resulting foreign currency liquidity to their domestic banking sector. In short, the failure of the international interbank market to provide funds to deficit banks would be met by increasing public funding. This type of public funding is usually characterized by two features: first, it is collateralized; second, the central banks entering into a foreign exchange swap agreement pay different interest rates, so that the deficit country ultimately pays a premium for the liquidity obtained.

In international financial markets outside the Eurozone there is, therefore, a hierarchy of funding as private funding is ultimately backstopped by public funding. The allocation is reflected in the price of funding, and a clear distinction is maintained between the two forms of funding. In contrast, the TARGET2 system is a peculiar and hybrid form of funding occurring within the Eurosystem but without foreign exchange swaps. In this light, standard monetary policy operations undertaken by central banks may end up financing cross-border liquidity flows among private agents. This is particularly clear as the interest rate that NCBs have to pay on their TARGET2 balances is the same as the rate they pay on the sums received through Main Refinancing Operations (ECB 2016b; ECB 2016c).

Consequently, the quantitative easing programs of the Eurosystem have had an impact on the vast accumulation of TARGET2 balances shown in Figure 4. Implementing monetary policy in the EMU by supporting specific financial assets (a characteristic of unconventional monetary policy) necessarily generates non-rebalancing liquidity outflows since the location of the sellers and the buyers of the securities may well be different. As an

example, Banca d'Italia is allowed to purchase *only* Italian government bonds under the Public Sector Purchase Programme, but the holders of Italian securities are located both domestically and abroad. Every time that Banca d'Italia purchases a bond of its government from abroad but within the area of the euro, the security moves "into" Italy, whilst the euros issued to acquire it move out of Italy and into the bank of the seller. Thus, a TARGET liability is created for Italy because of the purchasing of Italian government bonds that is not automatically balanced by private flows.

Now, the Bundesbank and German banks (the institutions of the surplus country) regularly receive capital flows from the periphery, which are then transferred abroad as Germany itself registers capital outflows. In effect, German financial institutions (both public and private) act as a conduit between financial investors within and without the EU (Eisenschmidt et al. 2017). Consequently, the implementation of quantitative easing would necessarily result in possible increases in TARGET2 balances. Quantitative easing allowed the Eurosystem to flood the banking system with "excess reserves", which indirectly financed capital outflows from peripheral countries, while the money markets have not acted as a rebalancing mechanism. The polarization of TARGET2 balances, moreover, reflected the decentralized implementation of quantitative easing within the Eurosystem. If quantitative easing operations were carried out by the ECB for example, the TARGET balances of all NCBs would look very different, although the aggregated Eurosystem balance sheet would not change in any way.

The appearance of stability was lent to the Eurozone, but without fundamentally improving its functioning. Even worse, these forms of selective support have not only been underpinned by the TARGET mechanism, but they have also exacerbated TARGET imbalances. The mechanism of TARGET has allowed for the recycling of liquidity from periphery to core by removing constraints on net cross border flows, while the balances of TARGET have strengthened the balance sheets of the private sector (especially finance) by drawing on the balance sheet of the public sector.

Needless to say, some public balance sheets have been weakened more than others. In effect, the TARGET mechanism allows for the hegemonic power of Germany to be intermediated by the architecture of the Eurosystem but masks it under the technical workings of monetary policy. German hegemony takes a monetary form as the appearance of a stable euro is coupled with the diverging accumulation of TARGET2 imbalances. On the one hand, TARGET2 divergences show the willingness of Germany to accept the build-up of deficits among member states. On the other, TARGET2 balances remain credit instruments of an undefined character that are treated as contingent debt relations.

Accumulating TARGET2 claims by Germany (and other surplus countries) occurs, first, because of the liquidity-supplying monetary policy of the Eurosystem and, second, the perception that the Bundesbank (and the financial system that has access to the Bundesbank balance sheet, i.e., monetary and financial institutions located in Germany) are safer locations for deposits and the intermediation of transactions. By the same tone, the implicit acceptance of large TARGET deficits for peripheral countries also supports the recycling of liquidity in the Eurozone, which allows banking sectors of core countries (mostly Germany, France, and Luxembourg) to maintain dominance both regionally and internationally. The interbank market of the EMU not only does not rebalance the outflows of liquidity from TARGET2 deficit countries, but appears actively to drain liquidity from the periphery into the core.[3]

In turn, this entails that the German Bundesbank acquires a clear position at the apex of the hierarchy of NCBs in the Eurosystem in terms of the acceptability of its liabilities (i.e., the reserves it issues), despite maintaining a legally equal status to the other NCBs. Failing to comply with the accumulation of TARGET2 surpluses would remove the possibility of using the Bundesbank as intermediary and the reserves issued by the Bundesbank as "store of value", thus de facto imposing the loss of par value of central bank reserves across the NCBs, thus implying the collapse of the euro as a common money across the EMU.

The role of TARGET2 balances in defining the hierarchical tiering of NCBs is further reinforced by the malleable nature of these balances. Indeed, as was already mentioned, TARGET balances are peculiar financial assets, without a proper definition, contract, or maturity. TARGET balances are perhaps best understood as "contingent debt", implying that whilst they are not active in normal times, they could perhaps be "activated" by the holder of the claims. In this sense, TARGET imbalances show that the Eurozone member countries are permanently on a knife-edge: stability is maintained as long as TARGET deficits could be accumulated but not settled.[4]

Considering that such an activation of TARGET balances has been threatened for countries exiting the monetary union (Draghi 2019), it follows that the greater the imbalances within TARGET2, the more costly would be a potential exit from the EMU. At the same time, the greater the imbalances within TARGET2, the more polarizing would be the liquidity flows, given that these are primarily driven by financial flows instead of current accounts. Deficits are a sword of Damocles over Italy and Spain, a fact that inevitably enters the risk considerations of financial investors, thus encouraging further deficits. This structural weakness of the EMU would not be rebalanced by changes in competitiveness given the already positive

current accounts of most crisis-hit countries. Only a shift from selective support for liquidity flows to profound institutional change (inclusive of fiscal transfers and full monetary unity) would be able to mend the instability of the Eurozone.

Moreover, the legal nature of TARGET balances also shows the power of the law as hegemonic tool in the EMU: TARGET balances are governed by German law as a result of novation (Murau and Giordano 2022). Indeed, at the inception of the Eurosystem, TARGET balances were supposed to be governed by the law of the issuer of the liabilities, thus making outstanding balances a matter of national law, which would be of paramount importance in case of redenomination of outstanding balances. However, the legal texts of the Eurosystem make it clear that any transaction made with the ECB must be governed by German law, given that the ECB is located in Frankfurt. The decision to engage in novation consequently made TARGET balances comply with German law regardless of the issuer, thus preventing national governments from the redenominating TARGET liabilities in case of exit.

The TARGET2 system supports the common currency, but its support amplifies the divergence between core and periphery in the EMU. It removes the requirement to settle cross-border transactions, but burdens member states with enormous external liabilities issued under foreign law. It seeks to maintain afloat the monetary union, but operates without transparency, it is amended behind closed doors, and leaves member states in profound ambiguity regarding the costs of exiting.

Conclusion

In this article it was shown that changes in the institutional framework of policymaking in the Eurozone have not promoted stability but masked the underlying weaknesses of the single and common currency. In particular, the article considered the operations the TARGET2 system paying close attention to distinguishing the clearing balances from the functioning of the mechanism. The distinction was important in establishing the concept of "selective support" as the rationale of policymaking in the EMU aimed at the survival of the euro but without depriving it of its organizing role in financial markets. This policy choice is driven by the persistent weaknesses of the monetary union and the hegemonic position of Germany within it. The outcome is still further imbalances, most prominently showing as TARGET2 balances that reflect the flow of liquidity from the periphery of the EMU toward its core.

Institutional change in the Eurozone creates programs and tools aimed at allowing the euro to survive rather than ensure its stability by altering its

architecture. This behavior results in selective support for the sectors and instruments necessary for the short-term survival of the euro. Without such support, the inconsistencies of the single and common currency circulating in a region that is far from unified would lead to its collapse. The only other option would be to foster a radical shift of the Eurozone from the integration of member states to the unification of monetary architectures and financial systems. Such a move, however, is extremely unlikely in the current predicament of the Eurozone.

In the absence of unification, selective support allows the euro to survive, but also entrenches intra-EMU imbalances in the form of divergent TARGET2 claims and liabilities, which ultimately exacerbate the instability of the union. Paradoxically, the lack of economic and legal clarity regarding the status of TARGET2 balances is also used a means of preventing the exit of a member state from the Eurozone through fear of what the implications might be. In this negative sense, then, TARGET2 balances reinforce member-state commitment to the Eurozone.

Selective support via TARGET2 confers hegemonic power upon the accumulator of intra-EMU claims, that is, to Germany. In this light, the functioning of the Eurosystem – and of the ECB within it – indicates that the mechanisms of the single currency reflect a hierarchical ordering of member states. Managing the stability of the monetary system of Europe – of both its members and its institutional architecture –points to the asymmetrical nature of monetary integration and the hegemonic relations within it.

Notes

1. CSPP: Corporate Sector Purchase Programme; PSPP: Public Sector Purchase Programme; ABSPP: Asset-Backed Securities Purchase Programme; CBPP3: third Covered Bonds Purchase Programme.
2. In the rest of this article "TARGET balances" refers to balances arising in 1999–2008, while "TARGET2 balances" refers to those occurring after 2008. Crucial for our purposes are TARGET2 balances.
3. Including flows of liquidity to France, which explains why France has maintained a relatively balanced TARGET position across time.
4. It is striking that precisely the opposite occurs in the Federal Reserve System, in which the district Federal banks have the obligation to settle the outstanding Interdistrict Settlement Account (ISA) balances every April (Koning 2012; Wolman 2013)

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Data availability statement

Data sharing is not applicable to this article as no new data were created or analyzed in this study.

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